Framing the Budget Debate for the Future

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Committee on the Budget
United States Senate
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Mr. Chairman and Members of the Committee, I appreciate this opportunity to discuss with you some of the challenges facing the Congress this year as it makes its decisions about the fiscal 2003 budget. This statement:

- reviews the latest baseline budget projections and suggests that the baseline may be outside the range of politically attainable paths;
- draws some straightforward lessons from the sharp and unexpected deterioration in the budget outlook over the past twelve months;
- argues that fiscal discipline remains important and that Congress should revise and extend the procedures and mechanisms that facilitated budgetary restraint during the 1990s; and
- makes the case for augmenting the fiscal flexibility available to future lawmakers by modifying the provisions of the Economic Growth and Tax Relief Reconciliation Act of 2001 (EGTRRA).

What a difference a year can make!

When the Congressional Budget Office(CBO) released its baseline budget projections a year ago, they showed growing surpluses over the 2002-11 period in both the unified budget and the on-budget accounts, surpluses that cumulated to $5.611 trillion and $3.122 trillion, respectively, over the ten years (see Chart 1). For many who had struggled through the dark decades of large and seemingly intractable deficits, CBO's January 2001 projections were like passing through the pearly gates to the

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promised land of fiscal plenty. Resources appeared to be available to address many of the nation's priorities simultaneously—to reduce tax burdens, strengthen defense, modernize Medicare, expand aid to education, reduce the ranks of uninsured, help farmers, boost national saving and so on. Spirited debates even developed over the maximum feasible pace at which debt held by the public could be retired and the investment dilemma Treasury would face when government ran surpluses after all of the public debt had been retired.

Last week, CBO released its latest baseline projections before this Committee. In sharp contrast to those of a year ago, they showed unified budget deficits for 2002 and 2003 and deficits in the on-budget accounts through 2009 (see Charts 2 and 3). The cumulative unified budget surplus for the 2002-11 period had shrunk to $1.601 trillion and the on-budget accounts were projected to have a cumulative deficit of $742 billion over the period (see Chart 1).

CBO carefully enumerated the factors behind the sharp deterioration in the baseline outlook. Over the short run—2002 and 2003—the changed economic forecast is the dominant explanation, accounting for 40 percent of the deterioration (see Chart 4). In the later years, the revenue loss attributable to EGTRRA and the associated debt service dominate, accounting for half of the total deterioration in the baseline budget outlook in the 2009-11 subperiod.

While CBO's more pessimistic projections of January 2002 represent a sharp contrast to those it made a year earlier, they need to be kept in perspective. Notwithstanding the wailing of those who would like to convey a sense of extreme fiscal crisis, the new projections do not foretell a return to the budget dynamic of the 1980s and early 1990s when, unless Congress took steps to curb the growth of spending or raise revenues, already large deficits would grow inexorably. Under the baseline scenario, relatively small deficits, which should cause little concern while the economy remains weak, turn into surpluses as the economy strengthens. This means that, if the economy unfolds along the path expected by most economists, the budget will not get mired in large deficits again unless the 107th Congress and its successors pass legislation that reduces revenues or increases spending above baseline levels.

However, as you know better than I do, it will be very difficult to adhere to the fiscal restraint implicit in the baseline and so the baseline projections may prove to be a somewhat misleading indicator of the attainable, let alone the likely, future budget outlook. Rarely have the policies underlying the baseline projections been as disconnected from the policy makers' agendas as they are today. The rules and conventions that govern the construction of the baseline budget appropriately do not take into account the partially completed business before the Congress, provisions of the tax code that expire but are likely to be extended, or initiatives with bipartisan support that seem highly likely to be enacted soon. A short list of such items before the 107th Congress would include the farm bill, a fiscal 2002 supplemental for defense and homeland security, extension of expiring provisions of the tax code, and adequate resources to cope with natural disasters. The rather sanguine picture that the CBO baseline portrays for the second half of the decade deteriorates moderately if one adds to the CBO baseline reasonable amounts for these priorities. This scenario is portrayed, in a very rough fashion, in Charts 1 through 3 by the bars and lines labeled "more realistic" projection. While the non-Social Security accounts remain in deficit throughout the projection period, small unified budget surpluses still characterize the second half of the ten-year projection period.

Abstracting from the uncertainty surrounding budget projections, even this picture is probably too optimistic. It does not encompass an economic stimulus package, the possibility that Congress might increase payments to Medicare providers above baseline levels as MedPAC has recommended, a Medicare prescription drug benefit, or added resources for defense, NIH, Amtrak, those without health insurance, and other perceived priorities. Of course, above-baseline spending in these areas could be financed by restraining spending in other programs below baseline levels and by closing so called tax loopholes. However, such tradeoffs are likely to be difficult in the current political environment where majorities are narrow and bipartisan consensus on policy matters elusive. In short, even without considering the unforeseen needs that inevitably will emerge as the decade unfolds, it will be a challenge just to maintain balance in the unified budget after the economy recovers from the recession.

Lessons from 2001

The experience of the past 12 months provides a textbook example of the uncertainties inherent in budget projections and underscores why such projections should be used with utmost caution when pushing forward legislative agendas.

The budget outlook changed dramatically from that assumed in the January 2001 CBO baseline for three reasons. First, there was a deliberate, major policy change—the enactment of the Economic Growth and Tax Relief Reconciliation Act of 2001—in June. This legislation reduced revenues and increased debt service costs by some $1.7 trillion over the 2002-11 period. It also preemptively provided beneficial fiscal stimulus to an economy that was sliding into recession and introduced considerable uncertainty in the future fiscal picture. This uncertainty derived from the act's failure to extend the many provisions of the tax code that expire between 2002 and 2010, its creation of two new provisions (AMT relief and a deduction for education expenses) that terminate at the end of 2004 and

2005, respectively, and its “Cinderella’s coach” provision which has the tax code revert, not to a pumpkin, but to its pre-EGTRRA structure at midnight on December 31, 2010.

Second, contrary to the expectations of CBO, OMB and most economists in January 2001, the economy slid into a recession that the NBER has determined started in April 2001. The recession reduced the growth rate of nominal GDP for 2001 by 1.5 percentage points below CBO's expectations and caused a sharp drop in corporate profits. The continued slide in stock market values reduced capital gains realizations and the value of stock options. These developments depressed revenue growth.

In July, when the Bureau of Economic Analysis issued revised national income and product account figures, it lowered its estimates of nominal and real GDP growth, investment, productivity increases and corporate profits for the 1998-2000 period. These revisions have cause some economists, CBO included, to dampen a bit their expectations about the economy's long-run growth potential. Less robust growth in the short and long run has reduced projected levels of nominal GDP and future budget surpluses.

Finally, the terrorist attacks of September 11 caused a sharp shift in the nation's priorities. The needs associated with an active military engagement abroad, the destruction and loss of life in New York, the Pentagon, and Pennsylvania, and increased homeland security and anti-bioterrorism measures became paramount. The president and Congress responded by appropriating for fiscal 2001 and 2002 tens of billions of dollars above baseline levels to meet these new priorities. And these amounts were viewed as only a down payment on a longer-term commitment.

One clear lesson that can be drawn from the experience of 2001 is that there is no way to predict with certainty today the nature or magnitude of tomorrow's priorities. This suggests that, in long-run budget planning, Congress should leave a considerable margin of fiscal flexibility for future lawmakers. A second lesson is that the strength of the economy, which has such a crucial impact on the budget, is not only impossible to predict with any certainty over the long run but also can be difficult to forecast accurately even in the short run. This second bitter pill suggests that Congress should exercise caution in its budgetary decisions, especially when the economy seems to be approaching a peak or trough in the business cycle.

Establishing a framework for the budget debate

Not only has the budget outlook changed dramatically over the past year, but the consensus framework in which budget issues were debated has dissipated and some of the procedures that restrained profligate behavior during the 1990s have expired. These developments will make it more difficult to maintain fiscal discipline in the future. Nevertheless, for several reasons, fiscal restraint should remain an important, if not paramount, goal of policy makers. First, healthy growth and economic stability are more likely if the federal government is not running large and persistent budget deficits. Second, the nation will be better able to cope with the unavoidable challenges posed by the aging of the population if fiscal discipline is maintained and the government is not saddled with large and growing debt service obligations when the baby boomers begin to retire. Third, policy choices tend to be more rational and debate less contentious when fiscal discipline prevails. In an environment of persistent deficits, policies designed to address the nation's problems often are constrained or distorted and, therefore, less effective. Symbolic rather than substantive responses to problems are too often adopted. Finally, policy makers are less likely to resort to procedural gimmickry—such as Constitutional amendments requiring a balanced budget and lock box prescriptions—if fiscal discipline is maintained.

The first step policy makers need to take to reestablish a framework for the budget debate is to agree on an appropriate fiscal goal for the nation. From the end of World War II through the early 1960s, the consensus fiscal goal of policy makers was to balance the administrative budget, a target attained in 6 of the 16 years from 1947 through 1962. From the mid 1960s through the late 1970s, the goal was refined to be balancing the unified budget over the business cycle. In other words, deficits would be tolerated when the economy was operating significantly below its capacity but surpluses would be expected when the economy's resources were fully utilized. Only once during this period was the target achieved. As deficits persisted and grew, the goal became balancing the unified budget no matter what the state of the economy, a goal that was finally achieved, quite unexpectedly, in fiscal 1998.

When rapid economic growth, a soaring stock market and political gridlock combined to generate surpluses in the government's non-Social Security accounts in fiscal 1999, policy makers began to consider raising the bar. By January of 2001, a broad bipartisan consensus had developed around the notion that, at a minimum, the nation's fiscal goal should be to balance or maintain small surpluses in the non Social Security accounts while devoting Social Security's surpluses to debt retirement or structural program reform. Some wanted to go farther and wall off the Medicare Hospital Insurance surpluses for debt reduction or Medicare reform. Lock box proposals, which the sponsors claimed would realize these goals, proliferated.

After September 11 discussions about the appropriate fiscal goal for the nation ceased. Nevertheless, the Budget Committees should, as part of their consideration of the fiscal 2003 budget resolution, attempt to develop a consensus around a long-run fiscal goal for the nation. It could be to balance the unified budget, achieve balance in the non Social Security accounts, or meet some other target. Of course, no single goal is analytically right or economically optimal. The choice of a target depends on judgments—how one values present versus future needs, how one values public versus private goods, and what one thinks is politically sustainable. What may be the appropriate goal for the current decade may be quite different from that which makes the most sense for the next ten years. While the CBO projections suggest that Congress will find it challenging just to sustain balance in the unified budget, I would urge you to set your sights higher and strive to maintain unified budget surpluses of 1 percent to 1.5 percent of GDP during good economic times. Maintaining balance in the non-Social Security budget would be a slightly more ambitious goal, but one with more political appeal.

Once a fiscal goal is agreed to, procedures must be established to achieve and sustain fiscal discipline. During the 1990s, this was accomplished through enactment every few years of multi year deficit reduction packages whose terms were enforced by discretionary spending caps and pay-as-you-go (PAYGO) restraints on mandatory spending and revenue measures. The system worked fairly well from fiscal 1991 through fiscal 1998 because the spending caps were achievable in the post Cold War environment, fear of deficits loomed large, the economy was strong, and political gridlock prevailed. After 1998, the effectiveness of this approach deteriorated. The spending caps established by the 1997 Balanced Budget Act, which called for real reductions in discretionary spending of roughly 10 percent between 1998 and 2002, were politically unsustainable in an era of growing surpluses. The payment reductions imposed on Medicare providers were too deep for many to absorb at a time when their costs were beginning to rise rapidly and payments from other sources were constrained. And so

Congress flouted the restraints of the Budget Enforcement Act. Nevertheless, gridlock on major initiatives and a strong economy kept the surpluses growing through fiscal 2000.

Notwithstanding the record of the past three years, experience suggests that multi-year discretionary spending caps and PAYGO restraints can serve useful roles if Congress wishes to adopt procedures that lead to the attainment of a specific fiscal goal sometime in the future. Prospectively establishing caps on discretionary spending several years in advance would almost certainly restrain spending below the levels that would result from a process in which limits were set annually through the budget resolution. To be effective, however, spending caps and PAYGO restraints must be realistic–they must reflect the overall budget situation, the fiscal goal, and changes in the political consensus. Both restraints must be flexible enough to accommodate the vicissitudes of the budget—they must be able to bend, but not too much.

Should the budget outlook improve markedly to the point where the fiscal goal was likely to be exceeded—the situation Congress faced in early 2001—some more sophisticated process than that of the Budget Enforcement Act would be more appropriate. Elsewhere I have suggested that, under such circumstances, it would be prudent to limit each Congress' ability to encumber future surpluses that were projected to exceed the fiscal goal. For example, if the goal were to maintain balance in the non Social Security portion of the budget and CBO's baseline projections showed large and growing on-budget surpluses, the budget resolution would be required to place limits on spending and revenue legislation so that new initiatives absorbed no more than 80 percent of the surpluses projected for the next two years, 70 percent of the surpluses projected for the following two years—on down to 40 percent of the surpluses projected for years nine and ten. Such a calibrated system recognizes that the uncertainty that surrounds budget projections increases the farther in the future one projects. It also reflects the reality that today's lawmakers may not be the best judges of the nation's needs five or ten years hence. If future legislators are left with some significant fiscal flexibility, they will be able to address the nation's problems without raising taxes, reducing spending on necessary programs, or increasing the deficit.

Developing fiscal flexibility for the future

Realistic estimates of the budget outlook, such as those discussed earlier in this statement, suggest that it will be a challenge to attain and then maintain balance in the unified budget if lawmakers complete the unfinished business before the 107th Congress. In other words, little if any of Social Security's surpluses will be available to pay down debt or invest in structural entitlement reforms over the next ten years. And nothing will be available for emerging priorities. In short, taxes will have to be raised, program spending cut, or unified budget deficits tolerated to address future problems.

Congress could avoid placing future policy makers in this painful predicament by adopting measures now that create greater fiscal flexibility in the future. The most straightforward approach would be to modify the provisions of the EGTRRA. From its enactment, this legislation was incomplete and required further action. The provisions that provide AMT relief and deductions for educational expenses terminate in mid-stream, and the entire act sunsets after 2010. With the deterioration in the long-run budget outlook and the emergence of new priorities, the uncertainty surrounding the level of tax relief that the nation will conider prudent after 2010 has increased.

To eliminate this uncertainty, consolidate the tax cuts that have already been implemented, and create greater fiscal flexibility for the future, it would be judicious to index and make permanent all of the currently effective provisions of EGTRRA and put the provisions that are not yet implemented on hold. As Congress debates the disposition of any future surpluses that exceed the agreed-upon fiscal goal, it would be free to activate the various frozen provisions. But they would have to compete with other national priorities for the available resources.

Very rough estimates suggest that this proposal would provide well over $300 billion in increased fiscal flexibility over the 2003-12 period relative to the CBO baseline. Compared to a scenario in which the AMT relief and education expense deductions are extended and EGTRRA is made permanent after 2010, the savings could well exceed $600 billion. A very rough idea of how this proposal would change the non-Social Security budget outlook is provided in Chart 5. Rather than facing continued budget deficits as depicted in the “more realistic” baseline scenario, on budget surplus would reemerge after 2010. These surpluses could be used for further tax cuts or other national priorities.

Some will characterize this proposal as a tax "increase." In fact, for both for 2003 and for the period after 2010, it represents a reduction in tax burdens imposed by current law. In addition, throughout the whole period, indexing the bottom bracket would provide tax relief, relative to current law, to the majority of taxpayers who face the bottom two marginal rates.

Conclusion

The budget outlook is not as rosy as it was 12 months ago. Notwithstanding the deterioration that we have already seen, the nation is in a far stronger fiscal position than it was anytime from the late 1970s through the mid 1990s. If the nation slips back into serious budget difficulties, it will be because of decisions yet to be made. With so many outstanding promises, however, it will be difficult to make the tough decisions needed to keep out of such difficulties. To strengthen its resolve and structure its actions, the Congress needs to lay out a clear fiscal goal for the nation and revise the budget process so that it can help attain that objective.

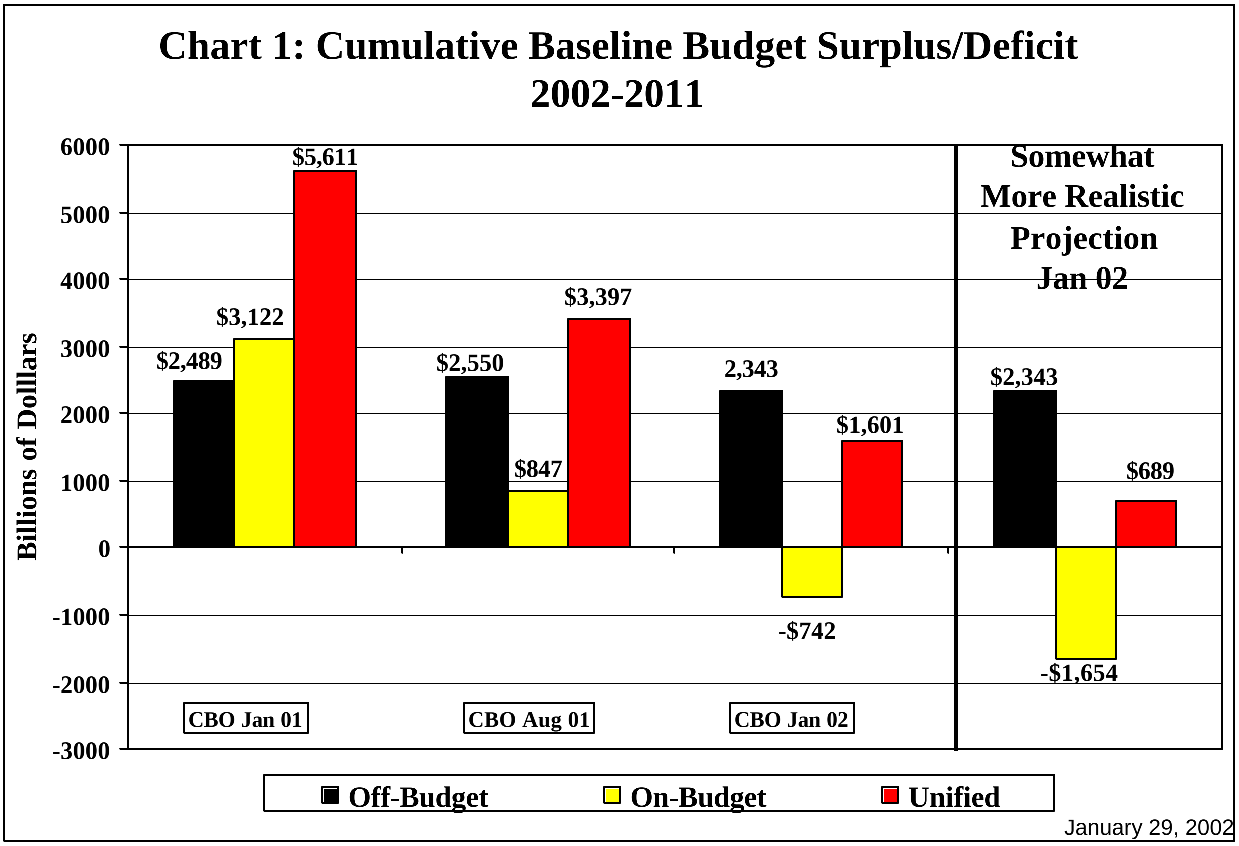
Chart 1: Cumulative Baseline Budget Surplus/Deficit
2002-2011
Billions of Dolllars
6000
5000
4000
3000
2000
1000
0
-1000
-2000
-3000
$2,489
$3,122
$5,611
$2,550
$847
$3,397
2,343
-$742
$1,601
$2,343
-$1,654
$689
Somewhat More Realistic Projection Jan 02
CBO Jan 01
CBO Aug 01
CBO Jan 02
Off-Budget
On-Budget
Unified
January 29, 2002

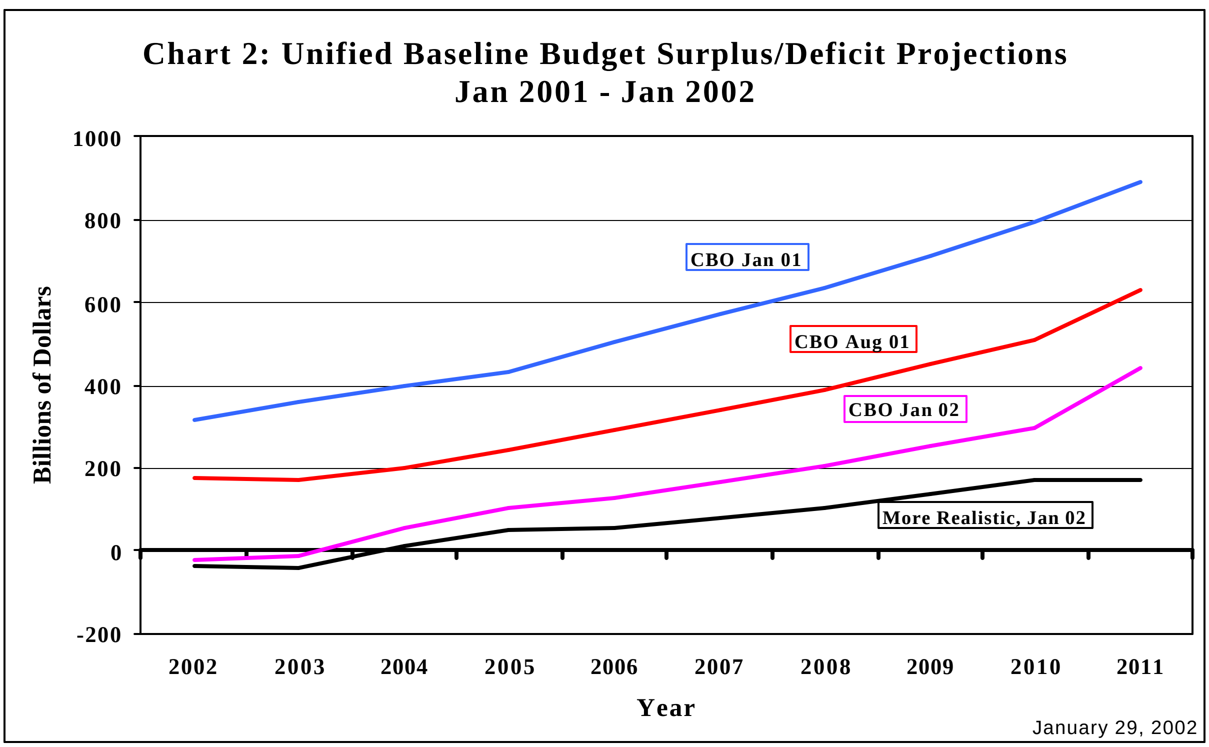
Chart 2: Unified Baseline Budget Surplus/Deficit Projections
Jan 2001 - Jan 2002
Billions of Dollars
1000
800
600
400
200
0
-200
CBO Jan 01
CBO Aug 01
CBO Jan 02
More Realistic, Jan 02
2002
2003
2004
2005
2006
2007
2008
2009
2010
2011
Year
January 29, 2002

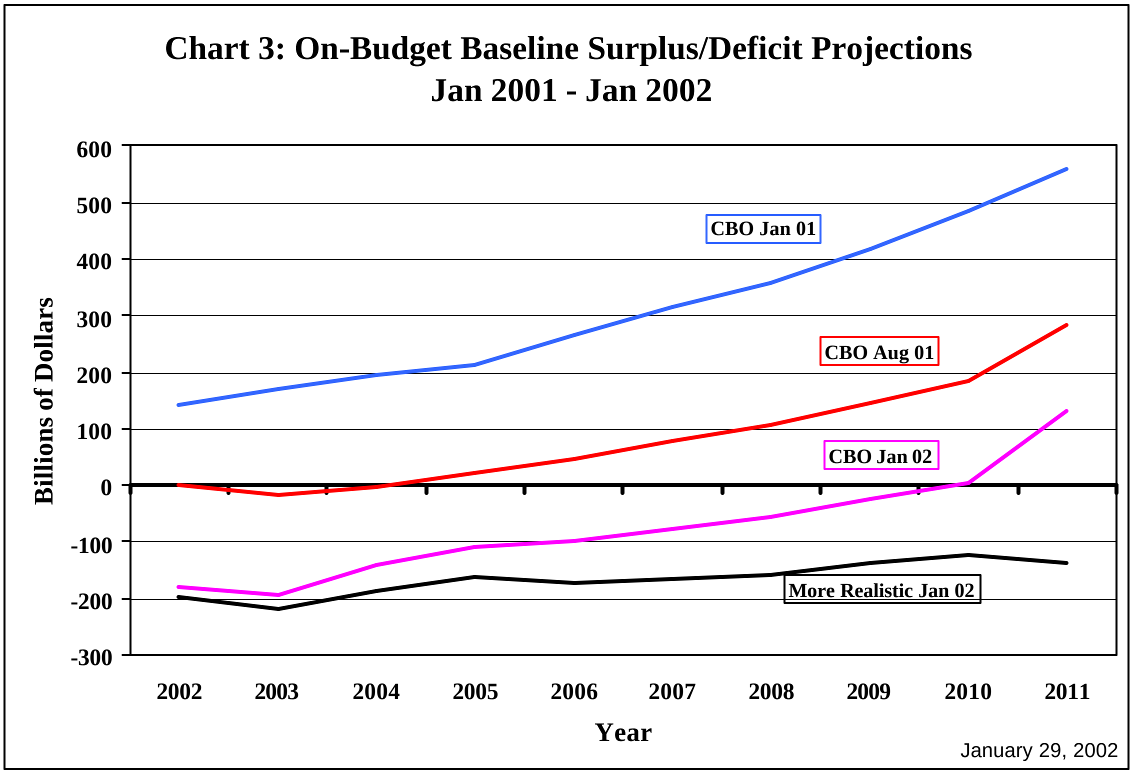
Chart 3: On-Budget Baseline Surplus/Deficit Projections
Jan 2001 - Jan 2002
Billions of Dollars
600
500
400
300
200
100
0
-100
-200
-300
CBO Jan 01
CBO Aug 01
CBO Jan 02
More Realistic Jan 02
2002
2003
2004
2005
2006
2007
2008
2009
2010
2011
Year
January 29, 2002

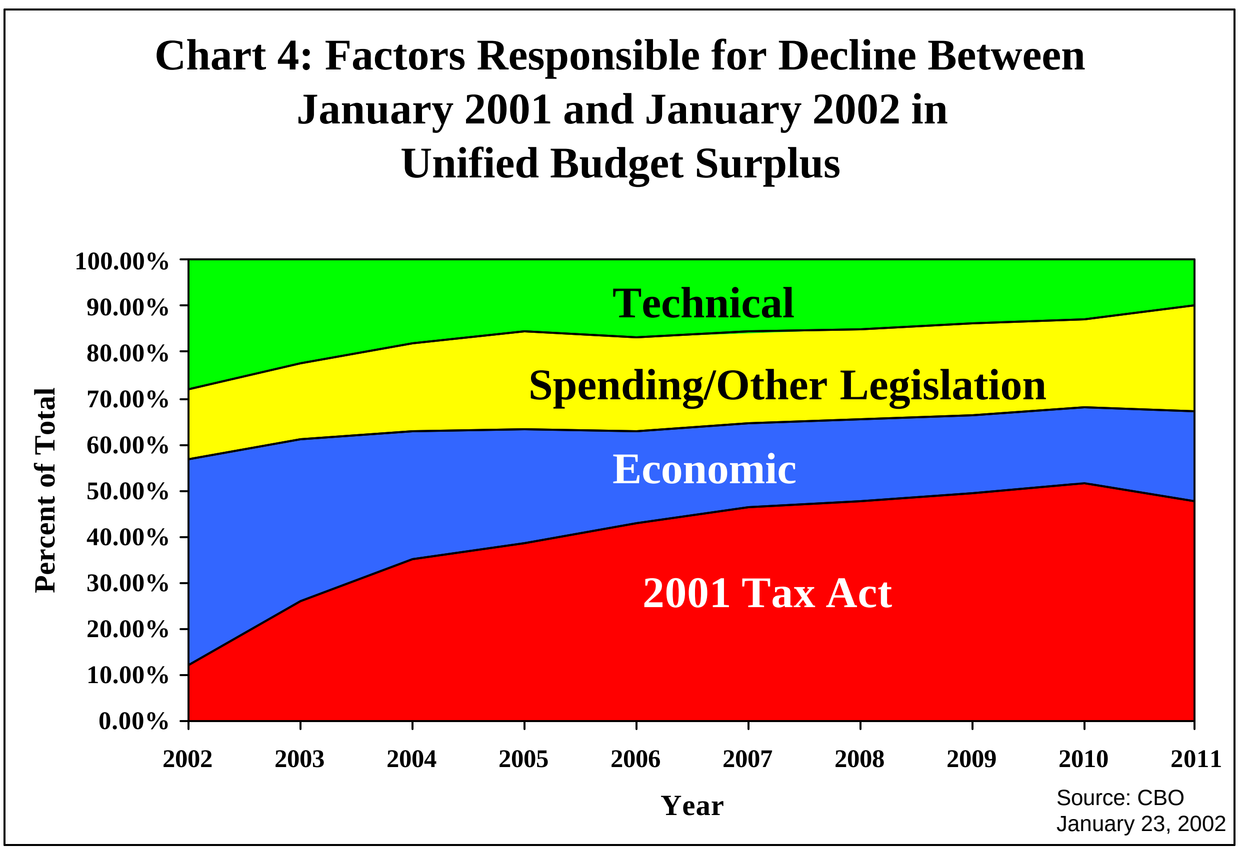
Chart 4: Factors Responsible for Decline Between
January 2001 and January 2002 in
Unified Budget Surplus
Percent of Total
100.00%
90.00%
80.00%
70.00%
60.00%
50.00%
40.00%
30.00%
20.00%
10.00%
0.00%
Technical
Spending/Other Legislation
Economic
2001 Tax Act
2002
2003
2004
2005
2006
2007
2008
2009
2010
2011
Year
Source: CBO
January 23, 2002

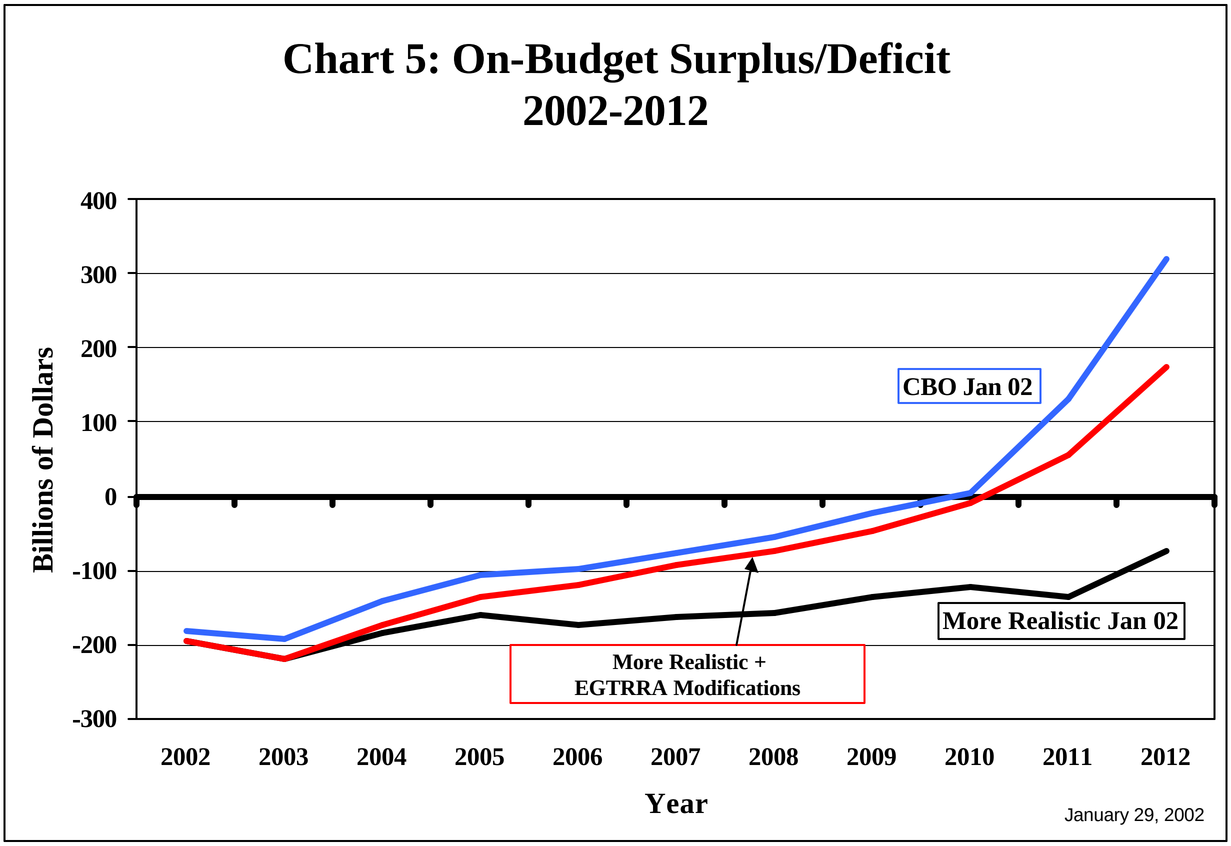
Chart 5: On-Budget Surplus/Deficit
2002-2012
400
300
200
100
0
-100
-200
-300
Billions of Dollars
CBO Jan 02
More Realistic Jan 02
More Realistic +
EGTRRA Modifications
2002
2003
2004
2005
2006
2007
2008
2009
2010
2011
2012
Year
January 29, 2002